

Hello Everyone,

German Banks don't usually appear on average American's radar screen, but the story of Deutsche Bank is both compelling and instructive.

I hope this missive helps you connect dots you might not normally connect. :>)

Signed, Your Way-To-Go-Hawaii-Little-League-World-Series-Champions Financial Advisor,

Greg

KKOB 08.27.2018 Deutsche Bank & Derivatives

Bob: So, Greg, on Friday, you said the world's major banks are all connected. And, you said, back in 2008, it wasn't Lehman's collapse itself, but rather the trillions in derivatives bets that made things so bad. Then, almost in passing, you said stock in Germany's biggest bank was down 90%---- and that seemed to surprise people.

Greg: It did. It's funny what jumps out for people. I believe people think that because Germany's economy is strong, their banks must be strong as well. But, it's not necessarily true. Deutsche Bank stock (and think of Deutsche as Germany's equivalent of JP Morgan) is actually down 93% from its 2008 highs; and the reasons are understandable. First, they have been found guilty multiple times for manipulating everything from interest rates to precious metals---and, the fines have been huge.

But, next, and Deutsche's bigger problem, is their derivatives book.

Bob: OK. Wait. There is that word again. You have explained derivatives before, but I need a refresher. Why is this always such a big deal to you?

Greg: I get that. Let's start with the refresher. A derivative is an investment that *derives its value* from something else. For example, if I buy a derivatives contract that says the *price of oil* will go up, I'm not really making an investment in oil itself, I'm just betting on its price. That's a derivative based on the price of oil. Meanwhile, since I'm betting the price will rise, obviously someone is betting the price will fall. Let's call that person my counterparty. Now, let's say the winner of the bet gets \$50,000.

Bob: So, this is why you say derivatives are like Vegas. An investment has substance behind it; a derivative is just a wager. It's air.

Greg: Right. But, it's air that banks can count as profits and losses on their balance sheets. Still, it gets weirder.

Bob, let's pretend you overhear me make my bet. You then turn to your friend and say, "I'll bet you \$20,000 Greg gets it right." Your friend says, "You're on!" Then some lady overhears you two betting and turns to her friend and says, "Hey, Betty, I'll bet you \$100,000 Bob's bet on Greg's bet is right." And, Betty says, "I'll take that \$100K bet!" And, so it goes, bets on bets on bets. Derivatives layered on derivatives. And, each bet takes us further away from objective reality...oil.

Oh, and by the way, you can bet on anything...interest rates, the euro, soybeans, the stock market. You name it, there's a derivative. According to the *Bank for International Settlements*, there are now over a quadrillion-dollars in derivatives bets swirling around the planet.

Bob: Wait...a thousand trillions in derivatives!? That's crazy. So, let's play the "what if" game. What if, someone can't pay the bet?

Greg: Ah. Now you've gotten to the counterparty problem. In 2008, the counterparty to \$35 trillion in derivatives was Lehman

2008, the counterparty to \$35 trillion in derivatives was Lehman Brothers. They couldn't pay. Yet, Lehman's ability to pay was counted on by other counterparties to ensure they could pay on their derivatives bets. Thus, if Lehman couldn't pay, that meant maybe Goldman couldn't pay, which meant maybe Credit Suisse couldn't pay, and on down the line. That's called contagion; and, in '08 it had to be stopped. Thus, the taxpayer bailouts.

Bob: And, that's the situation with German banks today, right? They have billions in loans to Turkey that could go belly up.

Greg: Right, and Deutsche also has a \$40 trillion derivatives book. Uh oh.

Bob: OK. I get this now. But, I also know you think there is opportunity in this, right?

Greg: Always. Wealth isn't usually destroyed. Wealth moves. You just want to be in front of the move. I'm out of time. If you want more on this, call me, 508-5550, or go to my website...zanettifinancial.com and I'll explain.

Bob: Thanks. Talk to you on Friday.

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